INTERNAL SERVICE FUND RATE RECOMMENDATIONS

A Report Prepared for the

Legislative Finance Committee

by

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INTRODUCTION

At the December 6, 2001, committee meeting, staff presented a report which documented a review of the processes for rate request submissions and the legislature's review and approval of rates for internal service funds. The report identified the relevant legislative duties for internal service funded programs as:

- ?? Establish fiscal public policy
- ?? Evaluate adequacy of fund financial stability
- ?? Review and approve fees and charges

Staff identified shortcomings of the current internal service rate-setting process and presented recommendations for process improvements that would enable the legislature to more effectively accomplish these duties. Two types of recommendations were proposed: 1) recommendations to improve how information is gathered and presented; and 2) recommendations to improve the decision process.

RECOMMENDATIONS TO IMPROVE HOW INFORMATION IS GATHERED AND PRESENTED

At the December meeting, the committee concurred in three staff recommendations associated with information gathering and presentation. The committee deferred until the March 2002 meeting two other recommendations regarding the internal service rate decisions.

The recommendations the committee concurred with are summarized as:

- ?? Presentations for rate requests should begin with the rates actually in effect and charged to customers at the end of the base budget year and all changes from these rates should be described and justified in decision packages
- ?? The Legislative Fiscal Analyst should use the information requirements contained in Appendix B of the staff report, Information Requirements for Internal Service Rate Setting, December 6, 2001, as the basis for negotiating with the Governor's budget director the format of the Executive Budget for internal service funded programs
- ?? Internal service funded programs should be presented to the legislature according to the format in Appendix C of the staff report, Information Requirements for Internal Service Rate Setting, December 6, 2001.

RECOMMENDATIONS TO IMPROVE THE DECISION PROCESS

The committee deferred decisions on the following staff recommendations to the March 2002 meeting to allow more time to consider the recommendations and to provide time on the agenda for agency comments:

?? Rate methodologies approved by the legislature should be the same as those actually charged to the customers (recommendation 4)

?? Rates defined as maintaining a working capital reserve should be expressly discouraged (recommendation 5).

Concurrence in recommendation 4 means that the rates charged to customers should be consistent with the rates approved by the legislature. This doesn't preclude programs from charging less than the rates approved by the legislature. Actual rates charged to customers would be structured the same as those approved by the legislature. As an example, if the legislature approved a rate of $40 **per occurrence** of an event, the program can't turn around and charge $80 **per hour**. Concurrence in this recommendation would provide consistency between the information the legislature uses to review and approve program rate requests and the financial data that results from providing the services funded by the rates. In essence, it would tie the decision process to program operations.

WORKING CAPITAL RESERVE RATES

The most common situation where agencies have requested and the legislature has approved rate structures different than the rate structures actually charged to customers is when the legislature approves a rate based on a working capital reserve. In this instance, the programs could not charge their customers a working capital reserve "rate," but because a working capital reserve rate is not directly billable, they must charge their customers specific rates for the services actually provided. Concurrence in recommendation 5 would strengthen the legislature's authority to set fiscal policy for the programs funded with internal service funds.

By approving a rate based on a working capital reserve, the legislature provides no policy direction for the operation of these programs, but grants them flexibility to provide services as it deems fit. No constraints are placed on program expenditures or the rates customers can be charged for services. The legislature has no input on capital equipment acquisitions unless they are specifically requested in separate legislation. The only constraint is on the amount of cash the programs can maintain in their treasury accounts (funds). For programs that provide services to federally funded programs, Office of Management and Budget Circular A-87, "Cost Principles for State, Local, and Tribal Governments" already limits working capital levels.

Of 51 internal service funds, only seven currently receive revenues through rates based on working capital reserves. Of these, all are in the Department of Administration, except for the Equipment Program in the Department of Transportation. Department of Administration programs funded with working capital reserve rates are: 1) Network Support Unit of the Accounting and Management Support Program (programming costs); 2) Procurement and Printing Program (Publications and Graphics, Central Stores, and Natural Gas Procurement); 3) Information Technology Services Division (all except for data network fee and Statewide Accounting, Budgeting, and Human Resource Support Bureau); and 4) Mail and Distribution Bureau (all except for interagency mail).

Attached please find the most recent financial-compliance audit for the two fiscal years ending June 30, 2001, for the Department of Administration. This audit identified concerns that internal service rates were not commensurate with costs. The audit also concluded that three of these seven internal service-funded programs, supported with working capital reserve rates, had year end working capital levels greater than the 60-day working capital allowed by federal standards. These three funds also exceeded the maximum rates contained in HB 2 – both violations of state law.

PROGRAM MANAGER CONCERNS

Managers of internal service-funded programs have raised the following concerns if a working capital rate structure is not used:

?? The legislature doesn't want to approve a large number of rates, many of which are not material

?? Approving specific rates would inhibit the program's flexibility to respond to future issues and to customer's changing needs

?? Rates submitted for legislative approval are developed too far ahead of when they will actually be charged, so accurate cost estimates can not be made and all factors anticipated

While addressing these concerns, the committee may wish to consider the following:

?? Legislative approval of internal service fund rates is a statutory requirement that was established so the legislature could set fiscal public policy for these programs. This occurred when HB 576 of the 1995 legislature removed the requirement to appropriate internal service funds. Current law states that the legislature shall approve fees and charges (rates) for internal service funds and that the programs cannot charge more than the rates approved by the legislature

?? There is no requirement for programs to charge the rates set by the legislature. The limiting requirements are that they cannot charge more than what the legislature approves and that rates must be commensurate with costs. If rates were accurately developed to recover costs for a service, material impacts on fund equity would result primarily from significant increases in major cost components associated with providing the service – volume fluctuations should have little impact except where significant overhead costs are recovered in the rates

?? Programs with working capital reserve rates approved by the legislature do not charge working capital as a rate to customers, but develop and charge their customers rates that are specific to the services provided. The service-specific rates the programs charge to their customers **are** developed each fiscal year and are the ones recommendations 4 and 5 suggest the legislature may wish to approve

?? Three options exist in current law that would allow flexibility to respond to unexpected and changing situations. These options include:

  - The inclusion of contingency language in HB 2 to allow for higher rate limits if certain conditions occur during the interim. To illustrate, assume that paper costs account for 30 percent of the expenses for providing copy services. If the cost of paper increases significantly above the cost used to develop these rates, the fund equity could be substantially impacted. Language could be included that allows a higher rate if paper costs increase to a certain level (e.g. If paper costs increase to $3.00 per ream, the rate for copying may be raised, but shall not exceed $0.10 per page)
  - A rate could be developed so a portion of the legislatively approved rate includes a cushion to allow the rate to be higher than operating parameters warrant if a valid argument can be made for the cushion. To illustrate using the above copying example, assume the estimate for paper used to develop the rate was $2.50 per ream. Also assume that the program could justify that paper costs could be $3.00 per ream if certain potential economic conditions occurred. In this instance, the legislature could approve $0.10 per page as the rate for copies, but the program may only need to charge $0.08 per page to recover costs under current conditions. If paper costs increase to $3.00 per ream, the program could increase the rate up to $0.10 per page if needed to maintain the fund in a viable condition
  - Inter-entity loans may be used to finance unexpected or unforeseen costs outside of approved rates

STATUTE CHANGE – PROCESS TO INCREASE RATES DURING THE INTERIM

In addition to these options available within current law, the committee may wish to consider another option to allow rate flexibility for programs to address unexpected circumstances that may occur during the interim. Adding a statutory process for increasing rates above the legislative rates could be structured similar to the current budget amendment process that allows an approving authority to increase appropriations under certain conditions. A process for increasing rates during the interim would address program managers' concerns over the legislative rates constraining program flexibility and would maintain fiscal policy setting within the legislature.

The committee may wish to direct staff to develop a process that would provide this flexibility during the interim and present it to the committee at a later meeting. It is envisioned that the new process would contain the following characteristics:

?? An approving authority would be granted authority to increase rates above the legislatively approved levels contained in HB 2 if the financial condition of the fund is adversely impacted because of:
    - Costs to purchase materials essential for providing a service increase and are beyond the program's control
    - Unanticipated rules or regulations drive up the cost of providing the service
    - Service volume changes place the maximum rates below the levels needed to recover costs

?? The rate increases resulting from the rate amendment process are temporary and must be requested from the next legislature before becoming part of the base rate

?? Rate increases and justifications for the increases must be reported to the Legislative Fiscal Analyst in a similar fashion as the budget amendment process

SUMMARY OF THE KEY ISSUES

To reiterate the issues surrounding the use of a working capital reserve rate, the committee may wish to keep the following questions in mind during deliberations:

> Does the legislature wish to give up its control of fiscal public policy for these programs and allow them to operate without an upper limit on the actual rates that can be charged to customers?
>
> Does the legislature wish to determine the appropriateness of expenditures on items such as capital equipment for these programs or provide them flexibility to make expenditures and purchase equipment as they deem necessary while potentially financing the expenditures with revenues derived from rate increases?

Attachment: Cover and pages 13 through 17, <u>Financial-Compliance Audit For the Two Fiscal Years Ended June 30, 2001</u>, Department of Administration (audit 01-12), Montana Legislative Audit Division, November 2001

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